(9)

No. 90-1491

In The

Supreme Court of the United States

October Term, 1991

UNION BANK,

Petitioner,

vs.

HERBERT WOLAS, Chapter 7 Trustee for the Estate of ZZZZ BEST CO., INC.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE AMERICAN COLLEGE OF REAL ESTATE LAWYERS AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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47

QUESTION ADDRESSED

The question addressed by the Amici Curiae is as follows:

> Does the ordinary course of business exception to the preference rules codified in 11 U.S.C. Section 547(c)(2) apply to scheduled payments on long term debt?

TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

TABLE OF AUTHORITIES

INTEREST OF THE AMICI CURIAE

The American College of Real Estate Lawyers ("ACREL") is a nonprofit corporation, organized on April 28, 1980, for the purpose, *inter alia*, of gathering together lawyers "to improve and reform real estate law and practice." (ACREL Articles of Incorporation at 2.) ACREL's membership consists of approximately 750 attorneys from every state and the District of Columbia who have concentrated their practice in real estate law for a period of ten years or more, and law school professors specializing in the field of real estate law. In addition, members elected to ACREL must have demonstrated a willingness to devote time to improving real property law through writing, teaching or participation in professional association activities.

The American Council of Life Insurance ("Council") is a nonprofit voluntary trade association, the membership of which totals 616 legal reserve life insurance companies doing business throughout the United States. The member companies of the Council account for 93.6 percent of the legal reserve life insurance in force in this country and afford protection to approximately 154 million insureds.

Life insurance companies are among the nation's largest long term lenders. At the end of 1989, life insurance companies held $254.2 billion of long term debt secured by mortgages on American real property, which represented 19.5 percent of the total assets held by life insurance companies in that year.[1] The Council was

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[1] American Council of Life Insurance, 1990 Life Insurance Fact Book 94 (ACLI, Washington, D.C. 1990).

directly involved in the events leading to the removal of the 45 day limitation from Section 547 of the Bankruptcy Code in 1984, and thus is particularly qualified to address the legislative intent issues regarding this statute raised by the Ninth Circuit.

This brief supports the position of the Petitioners in this case. Due to the Council's intimate participation in the legislative process and the background and lending experience of the *amici*, they are uniquely in a position to offer their expertise to this Court concerning the effect of the case below on long term lending. Additionally, the *amici* are competent to advise of the serious impact that the holding below, if not reversed, could have on real estate mortgagees, the willingness and ability of institutions to continue to make long term loans, and the life insurance and real estate industries.

SUMMARY OF ARGUMENT

Section 547 of Title 11 of the United States Code (the "Bankruptcy Code") subjects to attack and avoidance as preferential transfers, certain payments to creditors made within specified periods prior to a filing for protection under the Bankruptcy Code.[2] Section 547(c)(2) of the Bankruptcy Code (the "Ordinary Course Exception") excepts from such avoidance, certain payments of debt that are made in the ordinary course of business of the transferor and transferee. The Ninth Circuit incorrectly concludes in the decision below that, as a matter of law,

[2] 11 U.S.C. § 547 (1979 & Supp. 1991).

payments on long term debt do not fall within the Ordinary Course Exception. Your *amici* respectfully submit that no such exclusion of long term debt exists.

In 1984, Congress deleted the original limitation of the Ordinary Course Exception which restricted the applicability of the exception to transfers made within 45 days following the incurrence of a debt. The plain language of the Ordinary Course Exception as amended is clear and unambiguous – it applies to all debt that meets the ordinary course standards of the exception.

Where as here, the language of the statute is plain and unambiguous, reference to legislative history is unnecessary. Even if the legislative history of the 1984 Amendment to section 547(c)(2) is consulted, it will provide little insight into this issue, as long term debt is not specifically addressed. Your *amici* submit that evidence exists that Congress considered and understood that the removal of the 45 day limitation on the Ordinary Course Exception would allow the exception to apply to long term debt. Contrary to the Ninth Circuit's premise, long term lenders, including the Council, actively participated in the development of the 1984 Amendment to Section 547(c)(2).

The Ninth Circuit's unilateral exclusion of long term debt from the protection of the Ordinary Course Exception will place long term lenders at a severe disadvantage in the following instances, which will result in further tightening of credit markets and increased interest rates:

a. Lenders and purchasers of mortgaged backed securities, who have relied on the plain language of the

Ordinary Course Exception in making or purchasing interests secured by long term loans, will find that ordinary course payments under these loans may be recovered in the bankruptcy case of a borrower.

b. Read together with the Seventh Circuit's decision in *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989) (hereinafter referred to as the "*Deprizio*" case), the Ninth Circuit's decision in ZZZZ *Best* could make principal and interest payments made within one full year prior to bankruptcy subject to avoidance as preferences whenever the mortgage is only partially secured and the loan is guaranteed by an insider.

c. The Ninth Circuit's decision allows a debtor to abuse the bankruptcy laws by forestalling a lender's remedies to protect its security.

The exclusion of all long term lenders from the protection of Section 547(c)(2) is unnecessary to protect the integrity of the statute since the ordinary course of business requirement provides an ample statutory basis for courts to police the propriety of claims asserted under this exception.

ARGUMENT

I. THE PLAIN MEANING OF THE ORDINARY COURSE EXCEPTION AND ITS LEGISLATIVE HISTORY MANDATE INCLUSION OF LONG TERM DEBT WITHIN THE CLASS OF PROTECTED PAYMENTS.

A. The plain meaning of Section 547(c)(2) affords protection from preference attacks to scheduled payments on long term debt.

The Ordinary Course Exception explicitly excepts from preference avoidance transfers to creditors:

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and transferee; and

(C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2).

A fundamental issue in this case is whether the Ordinary Course Exception applies to scheduled repayments of long term debt. Traditional tenets of statutory construction require that this Court first look to the plain meaning of the statute to resolve any questions as to its application. *Toibb v. Radloff*, 59 U.S.L.W. 4633 (U.S. June 13, 1991) ("where, as here, the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear.").[3]

The plain meaning of the Ordinary Course Exception is that all payments that constitute ordinary course of business transfers pursuant to that section's three prong

[3] *Toibb*, 59 U.S.L.W. at 4634 (quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984)), involved the interpretation of Section 109 of the Bankruptcy Code. In holding that this section allowed individuals who were not engaged in business to file for relief under chapter 11, this Court noted that the plain language of Section 109 did not limit the protections of chapter 11 to business entities. This Court reached its decision despite the fact that "the structure and legislative history of chapter 11 indicate that [the] provision was intended primarily for the use of business debtors." *Toibb*, 59 U.S.L.W. at 4635.

test are excepted from preference avoidance. Section 547(c)(2) does not distinguish between short term and long term debt. Rather, the standard used for determining whether a payment is protected by the exception is whether the debt, its terms, and the payment are the kind found in the debtor's and creditor's ordinary course of business. Certainly, traditional long term real estate development loans and corporate bond indentures are examples of transactions which fall within the ordinary course of business of many debtors.

The Sixth Circuit adopted the foregoing analysis in its holding in *Gosch v. Burns (In re Finn)*, 909 F.2d 903 (6th Cir. 1990). In that case, the Sixth Circuit determined that since Congress had not limited the language of section 547(c)(2) to cover only particular transactions, no such limitation could be assumed or implied.

Thus, the plain language of the Ordinary Course Exception applies to all payments of long term debt.

B. The legislative history of the 1984 Amendment to Section 547(c)(2) does not support the exclusion of long term debt.

Even assuming *arguendo*, that some colorable argument could be fashioned that the language of the Ordinary Course Exception is ambiguous, the Ninth Circuit's premise regarding the legislative intent of revised Section 547(c)(2) is incorrect.[4]

[4] The Ninth Circuit's decision in ZZZZ *Best* that long term debt is excluded from the protection of the Ordinary Course

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Rather than acknowledge the absence of pertinent legislative history to the 1984 Amendment indicating that Congress intended to exclude long term lenders from the protection of the Ordinary Course Exception, the Ninth Circuit simply made the assumption that Congress intended the Ordinary Course Exception to apply only to short term or trade debt. The court reaches this conclusion because the statute, as originally enacted, contained a restriction that allowed protection only to those payments made within 45 days of the date on which the debt was incurred. Although the 1984 Amendment to Section 547(c)(2) deleted this 45 day restriction, the Ninth Circuit ignores the Amendment and assumes that the type of debt originally protected by the statute remains the only debt so protected.

Without pertinent legislative history to show that long term debt was intended to be excluded from section 547(c)(2),[5] the Ninth Circuit created the presumption that

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Exception is founded solely on its previous analysis of this issue in *CHG Int'l., Inc. v. Barclays Bank*, 897 F.2d 1479 (9th Cir., 1990) (hereinafter referred to as the "*CHG*" decision). References to the Ninth Circuit's reasoning are, therefore, to the *CHG* decision.

[5] The only legislative history cited by the Ninth Circuit in the *CHG* decision related to S. 445, which was passed by the Senate a year earlier in the ninety-eighth Congress. Section 221(b) of S.445 eliminated the 45 day requirement of Section 547(c)(2). The Senate Report, which was cited by the Ninth Circuit, observed that the 45 day requirement had placed "undue burdens upon creditors . . . [with] billing cycles greater than 45 days." *CHG*, 897 F.2d at 1484 n.6 (citing S. Rep.

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Congress did not intend to include long term loans under the Ordinary Course Exception. Once this judicially created presumption was in place, the Ninth Circuit required a showing of affirmative legislative history to prove that long term lending was to be included within the protection of Section 547(c)(2). In effect, the Ninth Circuit imposed on Congress the obligation to prove that it meant what it said in the text of the statute by writing a report or engaging in floor debate. This is hardly the proper use of the plain meaning rule of statutory construction.[6]

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No. 98-65, 98th Cong., 1st Sess. 60 (1983)). While this comment would seem to refer to trade debt and trade debt was certainly a major consideration of the drafters, it does not in any way limit the applicability of Section 547(c)(2) to such debt. Indeed on the Senate floor, Senator DeConcini indicated that the change included commercial paper, 130 Cong. Rec. S8897 (daily ed. June 29, 1984), and commentators are in general agreement that the Ordinary Course Exception includes short term debt, which is not necessarily trade debt. Moreover, if all the amendments to Section 547 that were contained in S. 445 are considered, it is clear that the Senate was not concerned solely with trade debt, but rather intended to address a range of issues including long term debt. See S. Rep. No. 98-65, 98th Cong. 1st Sess. 60 (1983) (explaining Section 221(a) of S. 445).

[6] There is ample indication of Congressional intent with respect to the scope of the preference provisions of the Bankruptcy Code, all of which is consistent with the application of Section 547(c)(2) to any debt meeting the ordinary course requirements, whether the debt be long or short term. The original legislative history that accompanied this section of the Bankruptcy Code stated that it was designed "to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage

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II. THE NINTH CIRCUIT MISCONSTRUES THE INTENTION OF CONGRESS WITH REGARD TO THE REMOVAL OF THE 45 DAY LIMITATION FROM SECTION 547(c)(2).

A. Contrary to the Ninth Circuit's conclusion, long term lenders participated actively in the development of the 1984 amendment to Section 547(c)(2).

The Ninth Circuit based its holding in *CHG* and the decision below on an unsupported assumption that Congress did not intend to "fundamentally change the scope of the ordinary course exception by including more than transactions which are substantially contemporaneous exchanges."[7] 897 F.2d at 1483.

To support its contention that Congress did not intend to deal with other than short term debt in the 1984 Amendment, the Ninth Circuit stated that trade creditors sought relief from Congress from the strict constraints of

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unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6329. The eventual elimination of the 45 day limitation and the opening up of the Ordinary Course Exception to all loans does not conflict in any way with this basic objective. Indeed, amended Section 547(c)(2) appears to accomplish Congressional goals where the earlier version did not.

[7] The Ninth Circuit appears to confuse the Ordinary Course Exception with substantially contemporaneous exchanges which were and continue to be excepted from preference avoidance under Section 547(c)(1).

a 45 day limitation, but that "long term lenders had not been active in seeking this change." 897 F.2d at 1484. Quite to the contrary, your *amicus*, the Council, through its Legislative Committee and Subcommittee on Federal Bankruptcy Legislation, actively participated on behalf of the life insurance industry, the archetypal long term lenders, in the discussions leading to this change.

During the period that the 1984 Amendment to Section 547(c)(2) was under consideration, the insurance industry expressed its concern about several aspects of long term lending that were adversely affected by the preference provisions. First was the common practice of insurance companies and other long term lenders to require a letter of credit as additional security for certain loans where lenders funded loans on partially completed improvements or on completed improvements that had not been fully leased. Second was the impact on loans in which an entity related to the borrower agreed to maintain a minimum net worth or minimum working capital of the borrower until certain financial conditions were met. Third was the enforceability of indemnity bonds such as completion and payment bonds obtained from a surety company in connection with a loan.

When the lender received regular payments of principal and interest on these long term loans, each of these third parties – the issuer of the letter of credit, the related entity agreeing to maintain a minimum net worth of the borrower, and the surety – was often relieved of its obligation to the lender. If the payments made by the borrower were later held to be voidable preferences, the lender would no longer have recourse against the third party on its undertaking.

In light of these concerns, the Council sought specific relief from preference attacks in these situations. The Council communicated this request to Congress along with several other suggestions for amendments to the Bankruptcy Code. On November 11, 1981 the Council wrote to Senator Robert J. Dole, then Chairman of the Subcommittee on Courts of the Committee on the Judiciary – the Committee responsible for the development of the 1984 Bankruptcy Code Amendments in the Senate. (A copy of this letter is appended hereto as Exhibit A.)

The letter in paragraph 5(a) contained a proposal for a new subsection (7) to 547(c) that would except transfers:

> to or for the benefit of a creditor to the extent such transfer was made to such creditor in payment of a debt evidenced by a note issued by the debtor and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, commitment to lend funds or bonds of indemnity issued by a bank or by an insurance company. (Appendix A, at App. 11).

The Council's proposal was similar to a bill, S.3023, introduced by Senator DeConcini a year earlier. Importantly, Senator DeConcini's earlier version of subsection (c)(7) included a requirement that the debt be incurred within nine months of the transfer. In referring to the original proposal by Senator DeConcini, the Council made the following statement in its letter to Senator Dole:

> The Council favored this provision but did not understand the reason it was limited to loans with a maturity of nine months or less. . . . We suggest the addition of the following language which tracks the language in S.3023 except that the limitation to loans with maturities of nine

months or less has been deleted. . . . (Appendix A, at App. 11).

The need for a new subsection (c)(7) was later rendered moot when congressional staff orally explained to the Council that they planned to propose the deletion of the 45 day limitation from Section 547(c)(2) to avoid the preference problem for ordinary course payments of principal and interest on long term loans. The deletion of the 45 day restriction resolved the Council's concern. Therefore, the Ninth Circuit's assumption that long term lenders played no role with respect to the long term lending issues involved in the Ordinary Course Exception is simply unfounded and inaccurate.

B. Congress, aware of the concerns of long term lenders, understood that the removal of the 45 day limitation from the Ordinary Course Exception permitted that section to apply to long term debt.

That Congress adverted to the contents of the letter from the Council is indicated by the incorporation into the Bankruptcy Code of several of the suggestions made in that letter[8] and by a letter acknowledging the efforts of the Council from Senator Dole. (A copy of this letter is

[8] For example, the letter suggested an amendment to protect a leasehold mortgagee or subtenant when the landlord in bankruptcy disaffirms the lease and the non-debtor tenant elects to treat the lease as terminated; this suggestion was included in the revised section 365(h). The Council also suggested that the Bankruptcy Code should include anti-*Durrett* (*Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir.

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appended hereto as Exhibit B). Given this involvement by long term lenders in the development of the 1984 Amendment to Section 547(c)(2), it seems inconceivable that a credible argument can be made that Congress did not know that the removal of the 45 day limitation from Section 547(c)(2) would save from preference attack regular payments of principal and interest on long term debt.

III. THE NINTH CIRCUIT'S EXCLUSION OF LONG TERM LENDERS FROM THE PROTECTION OF THE ORDINARY COURSE EXCEPTION PUTS SUCH LENDERS AT A SEVERE DISADVANTAGE AND MAKES FINANCING MORE DIFFICULT FOR PERSONS WITH LESS THAN THE HIGHEST CREDIT RATING.

A. Lenders have justifiably relied on the protection of Section 547(c)(2) in extending credit.

Relying on the clear and unambiguous language of the Ordinary Course Exception, long term lenders have extended credit to borrowers based on underwriting that presumed that payments of debt service in the ordinary course of business would not be subject to preference avoidance. The Seventh Circuit's decision in the *Deprizio* case provided added assurance to long term lenders. There, the Seventh Circuit explained the meaning of the Ordinary Course Exception and used scheduled

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1980)) language; this language was included in the Senate Bill but deleted at the request of Senator Metzenbaum shortly before the floor vote.

payments of long term debt as a prime example of transfers covered by that exception.[9]

Long term lenders do not expect that all payments under long term loans are subject to the Ordinary Course Exception. They realize that non-scheduled payments of interest or principal would be subject to avoidance because such payments are not made in the "ordinary course of business or financial affairs of the debtor."

The lenders' view that ordinary course transactions would be left undisturbed by the preference section is consistent with the legislative history of the original version of section 547(c)(2)[10], and with the clear and unambiguous language of the revised Ordinary Course Exception.

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[9] The court used the following example to illustrate the protection afforded ordinary course payments on long term debt:

> A creditor makes an unsecured loan guaranteed by an insider and requires monthly payments over a number of years. The trustee seeks to recover all of the payments during the year before the filing. To the extent the debtor paid on time, the creditor is protected by the current version of § 547(c)(2), the "ordinary course" rule.

Deprizio, 874 F.2d at 1200.

[10] *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 373, *reprinted in* 1978 U.S. Code Cong. & Admin. News at 6329.

B. Read with *Deprizio*, the Ninth Circuit's decision in *ZZZZ Best* will result in subjecting all payments of principal and interest on undersecured debt in the full year prior to bankruptcy to preference attack where the loan is guaranteed by an insider.

In *Deprizio*, the Seventh Circuit held that instead of the normal 90 day reachback period for preferences, a one-year reachback period is applicable in cases where loans are guaranteed by insiders. While the direct transferee in *Deprizio* was not an insider, the court reasoned that the payment was for the benefit of an insider because the payment freed the insider of liability on the guarantee and the insider was a creditor of the debtor by virtue of subrogation rights. As discussed above, the Seventh Circuit assured long term lenders that they were protected from preference attack on ordinary course debt service payments.

If the Ninth Circuit's interpretation of the Ordinary Course Exception were to be upheld and read in conjunction with *Deprizio*, all payments of interest and principal on undersecured loans in the year prior to a filing for bankruptcy could be subject to preference attack if the loan were guaranteed by an insider.

A guarantee by an insider is often the catalyst that permits financing transactions to go forward when the financial condition of a borrower would normally preclude the extension of credit. If payments made in the ordinary course of business during the year prior to bankruptcy can be withdrawn from lenders by the courts, lenders will restrict extensions of credit and only make loans to those who have demonstrated substantial financial stability – the credit crunch for start-up companies and other borrowers will become even tighter.

C. The Ninth Circuit's denial of the protection of Section 547(c)(2) to long term lenders encourages debtors to manipulate the bankruptcy laws to disadvantage such lenders unfairly.

Insurance companies, pension funds, commercial banks, and savings and loans regularly make loans for the development and acquisition of real estate. These loans are usually secured by mortgages on real estate and, if appropriate, security interests in rents received for use of real estate.

Often when a mortgage loan is in default, the value of the real estate that secures the mortgage debt is less than the amount due the mortgagee.[11] Regular debt payments to any partially secured real estate lender may be subject to preference attack under the Ninth Circuit's decision, because the lender will receive more as a result of receipt of debt payment than it would have received in a Chapter 7 case.

Knowing that the regular payments of principal and interest within the applicable preference period may be recovered and used to keep the business alive during the reorganization process, the borrower is encouraged to continue to make installment payments as they become due. By making the payments, the borrower is able to prevent the lender from discovering the borrower's

[11] If the value of the mortgaged real estate is and remains greater than the amount due to the mortgagee, prepetition payments of principal and interest on the debt do not constitute preferential transfers because in a Chapter 7 case the mortgagee would be fully satisfied by the proceeds from the sale of the real estate. 11 U.S.C. § 547(b)(5).

financial problems and from exercising default remedies set forth in the note and mortgage, thus forestalling foreclosure and in some cases, impeding the perfection of the lender's security interest in rents. When bankruptcy ensues, the borrower as debtor in possession may simply file a preference action and recover the installment payments made to a long term lender. The recovered payments will be available to fund Chapter 11 expenses. This manipulation confers an unfair benefit to the borrower at the expense and detriment of the lender.[12]

In those jurisdictions where it is necessary to take some affirmative act, such as obtaining the appointment of a receiver, to perfect the lender's security interest in rents, the borrower's free-ride strategy will either eliminate the mortgagee's lien on postpetition rents[13] or, at the very least, delay the mortgagee in obtaining recognition of the lien until some time after the petition is filed.[14] A

[12] In theory, any preferential payments that are recovered during a reorganization will benefit the creditors of the estate. In practice, however, a debtor will use the recovered preferential payments to pay current reorganization expenses.

[13] Although section 552(b) of the Code preserves the mortgagee's lien on rents, the lien must be perfected under state law, which in some instances requires an affirmative act by the mortgagee prior to the filing of a case under the Bankruptcy Code. *See In re Wynnewood House Associates*, 121 Bankr. 716 (Bankr. E.D.Pa. 1990). Thus, unless an installment payment is missed, the mortgagee will not be able to gain control of the rents, except in the rare instance where the mortgagee knows of some other material default by the owner-mortgagor.

[14] On various theories, courts have permitted perfection post-petition. For example, one line of cases has held that the post-petition filing of a motion for sequestration of rents in the

(Continued on following page)

mortgagor should not be able to use the bankruptcy laws to play this no-lose game.

CONCLUSION

The decision of the Ninth Circuit should be reversed.

Respectfully submitted,

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(Continued from previous page)

bankruptcy court is a proper method for perfecting the mortgagee's lien on rents. *See Virginia Beach Federal Savings & Loan Ass'n v. Wood*, 901 F.2d 849 (10th Cir. 1990).

APPENDIX A

American Council of Life Insurance

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November 11, 1981

The Honorable Robert J. Dole
Chairman, Subcommittee on Courts
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Senator Dole:

I am Chairman of the Subcommittee on Federal Bankruptcy Legislation of the American Council of Life Insurance. The Council has a membership of 525 life insurance companies which in the aggregate have 95% of the life insurance in force in the United States and hold 97% of the assets of all life insurers.

At the end of 1980, total assets of the life insurance companies aggregated more than $475 billion, invested mainly in corporate and government securities and mortgage loans to businesses and individuals. These funds represent the amounts that have been entrusted to our business by millions of individual policyholders and employee benefit plans. As part of its role in protecting these investments, the Council through the Subcommittee has monitored and supported changes in the bankruptcy laws which would improve the effective administration of the bankruptcy laws of the nation.

The Council appreciates this opportunity to comment on the provisions of S.863, which would amend the Bankruptcy Code. In reviewing the bill, we noted the following areas which are of concern to the industry or in

connection with which clarifying or technical changes would be appropriate.

1. Section 548 – Fraudulent Transfers.

   Durrett v. Washington National Insurance Co., 621 F. 2d 201 (5th Cir., 1980), held that a nonjudicial foreclosure sale was a transfer within the meaning of the former Bankruptcy Act and subject to being set aside as fraudulent if it were made without fair consideration within one year prior to the filing of the bankruptcy petition. This decision would seem equally applicable to cases under section 548 of the Bankruptcy Code. In *Durrett* it was agreed that the purchaser at the foreclosure sale was an innocent third party who saw the advertised sale in the paper, attended the sale and bid the amount of the mortgage indebtedness. The *Durrett* case was recently followed in the case of *Abramson v. Lakewood Bank & Trust Co.*, 647 F. 2d 547, (5th Cir. 1981), and in *In re Madrid*, 10 BR 795 (D.Nev., 1981). In those cases, the argument was made that since the definition of transfer includes involuntary transfers as well as voluntary transfers, a foreclosure sale would be a transfer within the meaning of the fraudulent transactions provisions. Such reasoning could apply whether the sale is a judicial or nonjudicial sale.

   Unless something is done to overrule the effect of *Durrett* and the cases following it, a serious dislocation will result in the mortgage market which is already suffering from tight money, disintermediation and inflation. Certainly lenders will hesitate to lend substantial sums of money in reliance on security upon which they may not be able to realize when a default occurs. Even worse, lenders are concerned that

under section 550(a)(2) they may be called upon to pay to the debtor the difference between the amount of the mortgage and what the bankruptcy court thinks the value of the property is.

Surely, the whole concept of a foreclosure sale is designed to obtain the most money possible on foreclosure. Of course, a foreclosure is a distress sale and is likely not to bring the same amount as a sale under normal market conditions. But, if there is substantial value in excess of the mortgage balance, an owner-debtor can normally raise the mortgage balance through substitute financing or third party bidding will raise the price toward such value. If a court can later determine that the sale price is not reasonably equivalent value and apply the fraudulent transactions provisions, the certainty necessary to successful mortgage financing would be lost.

What also concerns the lender is that even where it is clear to the lender that the property is worth no more than the amount of the mortgage, the mortgagee may be required to bid the property in at the full mortgage balance notwithstanding substantial transfer taxes that would be occasioned by such bid. Furthermore, having acquired the property, the mortgagee would not be in a position to rehabilitate it or sell it for a period of at least a year out of fear that the borrower may file in bankruptcy and the bankruptcy court during that period of time may find the foreclosure to have been "fraudulent".

To extend the fraudulent transactions provisions to mortgage loans often made years before bankruptcy not only makes no sense but will harm the economy and stifle mortgage investments at a time when they should be encouraged. In fact, it hurts the very owner-debtor it purports to protect. Competitive bidding will be

inhibited and third party bids will tend to be lower because of the risk that the transaction may later be declared void by a bankruptcy court, thus reducing the possibility of bids in excess of the mortgage balance (funds which would go to the owner-debtor) and increasing the likelihood of deficiency judgments.

It is therefore strongly urged that the Code be clarified in S.863 to restore the validity of foreclosure sales. This can be accomplished by amending the definition of "transfer" in section 101(40) of the Code to add in the end thereof, the following sentence:

> "For the purposes of section 548 of this title, the transfer of property as security for a loan under a mortgage, deed of trust, or other security agreement is deemed to take place at the time the mortgage, deed of trust or security interest is perfected and not at the time title is placed in the name of the secured party or third party purchaser pursuant to foreclosure, power of sale or other provisions of law permitting or providing for realization of the security upon the default of the borrower."

2. Landlord's Bankruptcy – Section 365(h).

a. Termination by Nonbankrupt Tenant. For some time we have been concerned about section 365(h) which, while designed to give a nonbankrupt tenant the right to remain in possession notwithstanding disaffirmance by the landlord's trustee, also gives the tenant the alternative of treating the lease as terminated. The effect of an election to terminate on leasehold mortgagees and sublessees is unclear. It was the Council's understanding at the time we participated in formation of the Bankruptcy Code that the language giving the tenant the

right to treat the lease as terminated was merely designed to restate nonbankruptcy law (that where the breach by the landlord is sufficient to give the tenant the right to terminate, such right would be preserved). The real estate industry, however, was concerned that the right as stated in section 365(h) could be construed as a special bankruptcy right to terminate that would override provisions of nonbankruptcy law or agreements the tenant might have with leasehold mortgagees or sublessees. Of course, the bankruptcy law would have no reason to give a nonbankrupt tenant the right to abrogate its agreements with third parties. However, in response to these concerns, the Council urged that the language giving the trustee the right to terminate be deleted from the statutory language and suggested legislative history to make it clear that no substantive change was intended by such deletion.

The drafters of S.863 dealt with the problem in a different way. Section 27(i) of S.863 adds a new subsection (3) providing that a subtenant or leasehold mortgagee could succeed to the right of the tenant to remain in possession if the tenant chose to treat the lease as terminated. It was the Council's view that this language was ambiguous because it did not deal with the question of how the succession to the rights of the tenant would be implemented. We were gratified to see the language in the Senate Report 97-150 (page 7) which helps to clarify this ambiguity. Since it is possible that the courts will not adhere to the interpretation in the legislative history, we still prefer the alternative approach of eliminating the language which could be construed as creating a special bankruptcy right on the part of the nonbankrupt tenant to terminate the lease.

Our recommendation was that in lieu of the proposed amendment we delete the words "may treat the lease as terminated by such rejection, or in the alternative," from the language of section 365(h)(1). The deleted language was not found in prior bankruptcy law where the non-bankrupt tenant's rights to terminate its lease were determined by nonbankruptcy law. As far as we are aware, the absence of such language did not create any problem.* To avoid any misunderstanding as to what the deletion was intended to do, we suggest that legislative history be inserted to the effect that such deletion is not intended to change the law, in language such as:

> "The words 'may treat the lease as terminated by such rejection, or, in the alternative', were deleted from §365(h)(1) in order to avoid an interpretation that a lessee, who is not the debtor, was afforded a special right to terminate its lease on disaffirmance by the debtor-lessor. A lessee, upon failure of the lessor's trustee on disaffirmance to perform lessor's obligations, should have the same rights as the lessee would have upon failure of the lessor to perform its

* Professor James Angell MacLachlan (who drafted the disaffirmance provisions of the Chandler Act) discussed the non-bankrupt tenant's rights on disaffirmance by the landlord in a letter to me of April 15, 1961 (26 *Bus. Law.* 1391, 1438-40 (1971)). He said: "There is nothing to stop the lessee from moving out on general contract principles, if the landlord [by disaffirmance] makes any breach going to the essence of the contract and I would suppose the inability of the lessor to respond in damages would tend to advance the point at which a breach would go to the essence of the contract. . . . [The tenant] certainly ought not to be compelled to continue performance notwithstanding the breach of important covenants."

> obligations under nonbankruptcy law. Section 365(g) states that a disaffirmance constitutes a breach of the lease. However, such breach should not of itself be the basis for termination of the lease by the lessee. The lessee should be able to terminate the lease only where the failure of the trustee to perform as the result of disaffirmance amounts to such a breach as would entitle the lessee to treat the lease as terminated by virtue of the terms of its lease, other nonbankruptcy law or other agreements the lessee has made with leasehold mortgagees, sublessees or other parties."

We think this would preserve the intent of section 365(h) to protect the tenants by enabling the tenant to remain in possession upon disaffirmance by its landlord while avoiding the ambiguity in the language of the current draft.

b. Meaning of "Possession". In addition to the termination problem in section 365(h), we were concerned about some recent testimony before the Subcommittee on Courts, U.S. Senate Committee on the Judiciary, which indicated that the protection of section 365(h) might apply only where the lessee is physically "in possession." If the word "possession" were interpreted so technically, doubts would be created about the efficacy of the protection granted by section 365(h) when property is subleased. Even if possession by a sublessee were considered possession by the lessee, it would not be clear whether a trustee for a landlord would be able to terminate if the sublessee had moved out or been evicted, or if, in connection with a "ground" lease of an entire office building, some space had become vacant.

We believe the testimony was intended to mean that the tenant had to have possession in the

sense of possession of the tenant's estate, in other words, that the lease had to have commenced at the time of disaffirmance. However, the word "possession" in the statute is troublesome for both tenants and leasehold mortgagees, and we recommend a further clarification to correct this problem. Our suggestion is that the words "in possession" be deleted from (h)(1) and (h)(2) and in its place the words "as lessee under a lease the term of which has commenced" be inserted. This would clear up the ambiguity without changing the intention of the section. In lieu of the foregoing, legislative history might be inserted to clarify this question, but a more desirable approach would be through the statutory change suggested.

3. Section 365(i) – Vendor's Bankruptcy.

While the new section 365(h)(3) proposed in S.863 would deal with the problem of the tenant's right to terminate on landlord's disaffirmance, there is no similar change in section 365(i) relating to the effect of disaffirmance of a contract of sale of real estate by a vendor. Like 365(h), section 365(i) provides that the vendee who is in possession (and here we believe physical possession is what was intended) may remain in possession, make his contracted for payments and receive a deed when the payments are made, or in the alternative, treat the contract as terminated.

As with section 365(h), we do not believe there was any intention to grant a special bankruptcy right in the nonbankrupt vendee to terminate the contract of sale unless the breach occasioned by the disaffirmance was such as to permit such termination under nonbankruptcy law or the terms of the contract of sale. However, the present language of the section will seriously limit the ability of the purchaser under a long-term

land sale contract to obtain financing secured by its growing equity under the contract. Therefore, as with section 365(h) it is urged that the right to treat the contract as terminated be deleted, or, in the alternative, that language similar to what is contained in S.863 with respect to section 365(h) be inserted as follows:

> "Section 365(i) of the United States Code is amended by addition of the following new subsection:
>
> '(3) In the event that the purchaser shall elect to treat such contract under this subsection as terminated, any holder of a security interest in such purchaser's interest may elect to succeed to the right of such purchaser to remain in possession.' "

4. Section 365(b)(2)(A) – Assumption of Leases by a Tenant's Trustee.

At the time of drafting of the Bankruptcy Code, the Council took a position in opposition to the absolute prohibition on termination of leases by a landlord on the tenant's bankruptcy and the consequent right of the trustee to assume or assign such leases. Instead, the Council had urged exceptions which would permit termination by a landlord where the lease was entered into before the effective date of the Code, where the property subject to the lease was not essential to a reorganization, or where the lease had a low base rent, with additional rent contingent on profits or sales. Especially in the latter situation, the Council felt public policy would dictate encouraging such leases rather than discouraging them. While the Senante [sic] bill incorporated exceptions similar to those suggested by the Council, these exceptions were not included in the bill as finally enacted. Thus the Bankruptcy Code Contains a general prohibition on

the landlord's right to terminate (with specific exceptions not relevant here) and grants a right to the trustee to assume the lease provided he cures defaults (other than defaults based on the financial condition of the debtor), compensates the party affected by the default and provides adequate assurance of future performance.

Under section 27(a) of S.863, the right of the trustee to assume has been expanded to eliminate the required curing of a default if the default were based on the financial condition of an "insider" of the debtor. Since many leases are entered into based upon the credit of a guarantor (who may often fit within the definition of "insider"), this provision will substantially expand the ability of the trustee to assume, and our members have expressed concern about this expansion. The Committee report states that the amendment "makes a technical change". It is our feeling that it goes much further than that and makes a substantive change in the rights of the lessor. Therefore, it is urged that this addition be deleted.

5. Section 547 – Preferential Transfers.

a. Letter of Credit Problem. The Council is concerned about the effect of section 547 as it applies to credit extended relying upon a letter of credit from the bank or insurance company. When the payment of this debt is made (normally after the 45-day "safe harbor" provided in section 547(c)(2)) the obligations of the issuer of the letter of credit end. If a bankruptcy trustee later sets aside such payments as unlawful preferences, the creditor no longer has recourse to the bank or insurance company issuing the letter of credit. To avoid this inequitable result and to encourage lenders to continue to make these

types of loans which are so important in commercial financing, Senator DeConcini introduced S.3023 on August 5, 1980, which would have added a new subsection (7) to section 547(c) to provide that the trustee might not avoid a transfer in this situation if the note did not have a maturity in excess of nine months. The Council favored this provision but did not understand the reason it was limited to loans with a maturity of nine months or less. S.3023 was never enacted into law and it has not been included in S.863.

The Council urges that protection be afforded to the lender in this situation. We suggest the addition of the following language which tracks the language in S.3023 except that the limitation to loans with maturities of nine months or less has been deleted:

> "(7) to or for the benefit of a creditor to the extent such transfer was made to such creditor in payment of a debt evidenced by a note issued by the debtor and payment of which was supported from time of its issuance until such transfer by an irrevocable letter of credit, commitment to lend funds or bonds of indemnity issued by a bank or by an insurance company."

We have reviewed a draft of proposed legislation designed to deal with many problems under the preference provisions and especially support the restoration of the requirement that the transfer may not be avoided unless the creditor receiving the transfer had reasonable cause to believe the debtor was insolvent. Since in the letter of credit situation, discussed above, the creditor will often be unaware of the debtor's insolvency, this change in section 547 would go a long way toward alleviating the inequities we discussed. However, this will not completely

solve the problem, and since the restoration of the reasonable cause to believe requirement is not certain, the Council urges the inclusion of the language set forth above.

b. Twist Cap Problem. The foregoing discussion deals with a situation where a debtor has made its payments in the ordinary course of business and such payments are later considered to be unlawful preference. In the *Twist Cap* case, (*Twist Cap v. Southeast Bank of Tampa*, 1 BR 284 (D.Fla., 1979)) the situation was somewhat different. There, the debtor whose obligation had been guaranteed had not made his payments when he filed a petition in bankruptcy. The creditor looked to the guarantor of the obligation. Before making the guaranty, the guarantor had obtained an agreement giving the guarantor a lien on the debtor's property to cover payments under the guaranty. The court stayed the payment by the guarantor to the creditor on the ground that such payment would activate a lien on the debtor's property and, the court believed, would amount to an unlawful preference. An amendment to restore the requirement that the creditor have reason to believe the debtor is insolvent would not solve the problem in this situation inasmuch as the debtor is already in bankruptcy at the time the creditor looks to the guarantor for payment.

To correct this situation we suggest that an amendment be made to section 362(b) by adding a new subsection (6) and renumbering subsections (b)(6) and (b)(7) as (b)(7) and (b)(8). The new subsection would provide that the filing of a petition would not operate as a stay:

> "(6) under subsection (a) of this section, of any act to collect, assess or recover against a guarantor of the debtor, a claim against the debtor that arose before the commencement of the case under this title;".

6. Section 1111 – Secured Creditor's Election.

Section 99 of S.863 amends section 1111(b) to provide, *inter alia*, that the subsection would apply "except where property of the estate that secures a claim is sold subject to section 363(k) of this title." While the Code presently has a similar exception, that exception would not seem to apply to an election under subsection (b)(2) for a full secured claim by a nonrecourse creditor. We are not certain why the exception was broadened.

Under the exception as it is currently worded, a nonrecourse secured party cannot convert its claim to a recourse claim where property is sold under section 363(k). The fear that this might be misinterpreted to limit the amount the nonrecourse secured party may offset against its bid on such a sale to a lower section 506 value given to the collateral is mitigated by the seeming ability of the nonrecourse secured party to protect itself from such a result by electing the full claim under section 1111(b)(2). The proposed amendment would prevent such an election and may result in consequences which would be highly inequitable.

If the secured party, due to competitive bidding is required to bid in excess of a section 506 valuation, that higher amount should represent the current value and is certainly not in excess of the true value of the property. Thus, the secured party should be able to offset against its bid amounts owing to the secured party as long as the debt equals the amount of the bid.

It is difficult to understand the reason for the exception in section 1111(b) or for that matter

the reason for the exception at all. The legislative history seems to indicate that the exception as it now is contained in the Code was inserted because the section 1111 election was unnecessary when the property was sold, since the secured party had a right "to bid in the full amount of his allowed claim at any sale of collateral under section 363(k) of the House amendment." (124 Cong. Rec. S.17420 (daily ed. Oct. 6, 1978)). However, as discussed above, it is not clear that the allowed claim for a nonrecourse secured party would equal the debt and thus the right to offset the full claim may not be as certain as the legislative history draftsmen assume. Since the elimination of the exception both from the present language and the amendment would seem to cause no harm and would avoid the problem we raise, the Council recommends deletion of the words "except where property of the estate that secures a claim is sold subject to section 363(k) of this title" in section 99 of S.863.

7. Technical Corrections. The following three provisions of S.863 contain what seem to be typographical or technical errors:

   a. Section 101(26)(B). In defining when a partnership is insolvent, section 1(f) of S.863 changes the word "and" to "or" at the end of subsection (i). This change from a conjunctive to the disjunctive was surely not intended. The definition is intended to say that a partnership is involvent when the sum of the partnership debts is greater than the partnership's assets *and* the net worth of the individual partners. With the change to "or" a partnership having asserts of $1 billion and liabilities of $300,000 would be insolvent if the individual partner's aggregate net worth were under $300,000. Also,

the disjunctive is inconsistent with the beginning of the definition in (B) which refers to the "aggregate" of (i) and (ii).

   b. Section 502(b)(7). Section 30(b) of S.863 would redesignate section 502(b)(7) as section 502(b)(6) and would add in subparagraph (A) the words "without acceleration". These words were retained in subparagraph (B) where they would seem appropriate. However, in subparagraph (A) the insert makes no sense since the amounts being referred to are rents reserved for specific periods, i.e., the rent reserved for the rental year during which the termination occurs or 15% for the remaining term of the lease not exceeding three years. It would seem that these words were included in subparagraph (A) in error and keeping them there would cause confusion as to how to apply the remainder of that subparagraph. It is therefore urged that the words "without acceleration" in subparagraph (A) be deleted.

   c. Section 507(b). This section provides that where adequate protection is given to the holder of a claim secured by a lien on real property and such adequate protection proves to be insufficient, the claim of the creditor will be given priority over every other claim allowable under section 507 (a)(1). Section 34(b) of S.863 adds language to section 507(b) apparently designed to protect parties who were denied adequate protection on the ground that such protection was not necessary, but nevertheless suffered a loss. To accomplish this, section 34(b) adds "or if the court finds that there is adequate protection of such interest by a lien on such property. . . . "

> While we applaud the purpose of the amendment, the Council believes that the language could be construed too narrowly. A creditor should be entitled to the same priority where the court incorrectly denies adequate protection as when the court incorrectly finds that there is adequate protection by reason of a lien on the property. It is therefore recommended that the above-quoted language be changed to read "or if the court does not provide adequate protection."*

We very much appreciate this opportunity to comment on the provisions of S. 863 which propose amendments to the Bankruptcy Code. If you have any questions or if I can be of any further assistance, please do not hesitate to

* This change will also avoid a conceptual problem arising out of the present language which seems to have been based on the so-called "cushion" cases where the courts have in some cases considered value of the collateral in excess of the debt being, in itself, "adequate protection". This is not conceptually correct. Section 361 indicates that adequate protection is something the court or trustee provides to a creditor whose interest in the debtor's interest in collateral is diminished by a stay, use of the collateral and the like, not something the creditor already has. The courts in the "cushion" cases should have stated the issue as a question of whether the existence of the cushion meant that there has been no decrease in the value of the secured party's interest in the debtor's interest in the property. (For the record, the Council believes that the value of the secured party's interest is decreased notwithstanding the existence of a cushion (see, for example, section 506(b) which provides that the secured creditor is entitled to post petition interest to the extent of the cushion)). The language of the proposed amendment to section 507(b) would tend to support this conceptual misunderstanding and should be changed.

contact me or Charles King, Assistant General Counsel, American Council of Life Insurance.

Sincerely,

/s/ Robert M. Zinman
Robert M. Zinman
Chairman
Subcommittee on Federal Bankruptcy Legislation
American Council of Life Insurance and
Vice-President and Investment Counsel
Metropolitan Life Insurance Company

cc: Members of the Subcommittee on Courts

APPENDIX B

United States Senate

COMMITTEE ON THE JUDICIARY
WASHINGTON, D.C. 20510

June 13, 1983

Honorable Richard Schweiker
President
American Council of Life Insurers
1850 K Street, N. W.
Washington, D.C. 20006

Dear Dick:

As you are probably aware, the Senate recently completed action on S. 445, my bill to reform the federal bankruptcy laws. The purpose of this bill was to correct defects in the Bankruptcy Code which have served to create inefficiencies and delays in the courts, encouraged needless filings, and inhibited good faith creditors in recovering upon legitimate claims. The bill, as passed by the Senate, contains a number of provisions which are of particular importance to the life insurance industry.

I am writing to express my appreciation for the invaluable contribution of two individuals, acting on behalf of the Council, who worked closely with members of my staff in framing the final legislation. Those persons are Mr. Robert Zinman, Vice-President and Investment Counsel of Metropolitan Life Insurance Company, and Mr. Charles King, Assistant General Counsel to the ACLI. Mr. Zinman and Mr. King were helpful in providing technical advice and drafting assistance, as well as liaison with important members of the industry and members of the Congress. The inclusion of language in the bill which will help protect the interests of life insurance companies

involved in bankruptcy proceedings was a direct result of the efforts of these two gentlemen, and they should be commended for their excellent work.

I trust that you are finding your new responsibilities challenging and rewarding, and I wish you continued success with the ACLI.

Sincerely yours,

/s/ Bob
BOB DOLE
United States Senate

cc: Charles King
Robert Zinman

BD:dcp